REDWOOD TRUST INC
Form 10-Q
August 04, 2017

UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: June 30, 2017

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _______________ to _______________.
Commission File Number 1-13759

REDWOOD TRUST, INC.
(Exact Name of Registrant as Specified in Its Charter)

Maryland	68-0329422
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

One Belvedere Place, Suite 300 Mill Valley, California	94941
(Address of Principal Executive Offices)	(Zip Code)

(415) 389-7373
(Registrant's Telephone Number, Including Area Code)
Not Applicable
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	o

Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company o
Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, $0.01 par value per share 77,116,538 shares outstanding as of August 1, 2017

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2017 FORM 10-Q REPORT
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In Thousands, except Share Data) (Unaudited)	June 30, 2017	December 31, 2016
ASSETS [1]		
Residential loans, held-for-sale, at fair value	$837,371	$835,399
Residential loans, held-for-investment, at fair value	3,067,920	3,052,652
Real estate securities, at fair value	1,218,503	1,018,439
Mortgage servicing rights, at fair value	63,770	118,526
Cash and cash equivalents	217,218	212,844
Total earning assets	5,404,782	5,237,860
Restricted cash	2,006	8,623
Accrued interest receivable	20,101	18,454
Derivative assets	12,264	36,595
Other assets	216,329	181,945
Total Assets	$5,655,482	$5,483,477
LIABILITIES AND EQUITY [1]		
Liabilities		
Short-term debt [2]	$1,294,807	$791,539
Accrued interest payable	9,939	9,608
Derivative liabilities	69,175	66,329
Accrued expenses and other liabilities	73,185	72,428
Asset-backed securities issued, at fair value	692,606	773,462
Long-term debt, net	2,336,346	2,620,683
Total liabilities	4,476,058	4,334,049
Equity		
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 77,116,875 and 76,834,663 issued and outstanding	771	768
Additional paid-in capital	1,679,475	1,676,486
Accumulated other comprehensive income	69,676	71,853
Cumulative earnings	1,223,228	1,149,935
Cumulative distributions to stockholders	(1,793,726)	(1,749,614)
Total equity	1,179,424	1,149,428
Total Liabilities and Equity	$5,655,482	$5,483,477

(1) Our consolidated balance sheets include assets of consolidated variable interest entities ("VIEs") that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to Redwood Trust, Inc. or its affiliates. At June 30, 2017 and December 31, 2016, assets of consolidated VIEs totaled $713,404 and $798,317, respectively. At June 30, 2017 and December 31, 2016, liabilities of consolidated VIEs totaled $693,137 and $773,980, respectively. See Note 4 for further discussion.

(2) During the second quarter of 2017, our convertible notes were reclassified from Long-term debt, net to Short-term debt as the maturity of the notes was less than one year as of April 2017.

The accompanying notes are an integral part of these consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, except Share Data)	Three Months Ended June 30,		Six Months Ended June 30,	
(Unaudited)	2017	2016	2017	2016
Interest Income				
Residential loans	$36,635	$ 35,154	$70,997	$ 66,554
Commercial loans	263	12,921	345	22,381
Real estate securities	21,826	18,417	41,643	39,512
Other interest income	500	295	867	668
Total interest income	59,224	66,787	113,852	129,115
Interest Expense				
Short-term debt	(9,350)	(5,337)	(13,803)	(12,034)
Asset-backed securities issued	(3,705)	(3,982)	(7,235)	(8,264)
Long-term debt	(11,179)	(13,125)	(24,227)	(26,096)
Total interest expense	(24,234)	(22,444)	(45,265)	(46,394)
Net Interest Income	34,990	44,343	68,587	82,721
Reversal of provision for loan losses	—	6,532	—	6,243
Net Interest Income after Provision	34,990	50,875	68,587	88,964
Non-interest Income				
Mortgage banking activities, net	12,046	7,728	29,650	14,946
Mortgage servicing rights income, net	2,778	2,783	4,491	9,064
Investment fair value changes, net	8,115	(11,066)	9,666	(30,604)
Other income	986	1,559	2,170	2,514
Realized gains, net	1,372	9,884	7,075	19,422
Total non-interest income, net	25,297	10,888	53,052	15,342
Operating expenses	(18,641)	(20,155)	(36,867)	(50,607)
Net Income before Provision for Income Taxes	41,646	41,608	84,772	53,699
Provision for income taxes	(5,322)	(327)	(11,479)	(355)
Net Income	$36,324	$ 41,281	$73,293	$ 53,344
Basic earnings per common share	$0.46	$ 0.52	$0.93	$ 0.67
Diluted earnings per common share	$0.43	$ 0.48	$0.85	$ 0.67
Regular dividends declared per common share	$0.28	$ 0.28	$0.56	$ 0.56
Basic weighted average shares outstanding	76,819,703	76,664,829	76,779,178	76,901,255
Diluted weighted average shares outstanding	97,494,144	97,761,936	97,718,550	88,728,380

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
(Unaudited)	2017	2016	2017	2016
Net Income	$36,324	$41,281	$73,293	$53,344
Other comprehensive income (loss):				
Net unrealized gain (loss) on available-for-sale securities [(1)]	1,811	6,260	4,741	(3,843)
Reclassification of unrealized gain on available-for-sale securities to net income	(2,322)	(7,711)	(6,250)	(18,664)
Net unrealized loss on interest rate agreements	(2,429)	(8,949)	(696)	(23,192)
Reclassification of unrealized loss on interest rate agreements to net income	14	19	28	37
Total other comprehensive income (loss)	(2,926)	(10,381)	(2,177)	(45,662)
Total Comprehensive Income	$33,398	$30,900	$71,116	$7,682

(1) Amounts are presented net of tax benefit (provision) of $0.1 million and $(0.1) million for the three and six months ended June 30, 2017, respectively, and $0.3 million and $0.4 million for the three and six months ended June 30, 2016, respectively.

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Six Months Ended June 30, 2017

(In Thousands, except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2016	76,834,663	$ 768	$ 1,676,486	$ 71,853	$ 1,149,935	$ (1,749,614)	$ 1,149,428
Net income	—	—	—	—	73,293	—	73,293
Other comprehensive loss	—	—	—	(2,177)	—	—	(2,177)
Employee stock purchase and incentive plans	282,212	3	(2,388)	—	—	—	(2,385)
Non-cash equity award compensation	—	—	5,377	—	—	—	5,377
Common dividends declared	—	—	—	—	—	(44,112)	(44,112)
June 30, 2017	77,116,875	$ 771	$ 1,679,475	$ 69,676	$ 1,223,228	$ (1,793,726)	$ 1,179,424

For the Six Months Ended June 30, 2016

(In Thousands, except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2015	78,162,765	$ 782	$ 1,695,956	$ 91,993	$ 1,018,683	$ (1,661,149)	$ 1,146,265
Net income	—	—	—	—	53,344	—	53,344
Other comprehensive loss	—	—	—	(45,662)	—	—	(45,662)
Employee stock purchase and incentive plans	431,156	4	(4,249)	—	—	—	(4,245)
Non-cash equity award compensation	—	—	8,488	—	—	—	8,488
Share repurchases	(1,658,868)	(17)	(21,267)	—	—	—	(21,284)
Common dividends declared	—	—	—	—	—	(44,303)	(44,303)
June 30, 2016	76,935,053	$ 769	$ 1,678,928	$ 46,331	$ 1,072,027	$ (1,705,452)	$ 1,092,603

The accompanying notes are an integral part of these consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Six Months Ended June 30, 2017	 2016
Cash Flows From Operating Activities:		
Net income	$73,293	$53,344
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(9,638)	(13,945)
Depreciation and amortization of non-financial assets	605	575
Purchases of held-for-sale loans	(2,309,856)	(2,578,592)
Proceeds from sales of held-for-sale loans	2,031,326	2,158,601
Principal payments on held-for-sale loans	22,093	35,649
Net settlements of derivatives	776	(9,427)
Provision for loan losses	—	(6,243)
Non-cash equity award compensation expense	5,377	8,488
Market valuation adjustments	(30,743)	25,584
Realized gains, net	(7,075)	(19,422)
Net change in:		
Accrued interest receivable and other assets	(26,226)	(20,667)
Accrued interest payable and accrued expenses and other liabilities	(16,840)	5,390
Net cash used in operating activities	(266,908)	(360,665)
Cash Flows From Investing Activities:		
Proceeds from sales of loans held-for-investment	—	11,395
Principal payments on loans held-for-investment	258,267	354,188
Purchases of real estate securities	(236,036)	(138,527)
Proceeds from sales of real estate securities	99,121	451,262
Principal payments on real estate securities	34,752	41,466
Purchase of mortgage servicing rights	(316)	(13,766)
Proceeds from sales of mortgage servicing rights	43,177	28,268
Net change in restricted cash	6,617	(2,726)
Net cash provided by investing activities	205,582	731,560
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	2,070,873	2,184,069
Repayments on short-term debt	(1,855,233)	(2,980,027)
Repayments on asset-backed securities issued	(103,371)	(158,519)
Proceeds from issuance of long-term debt	—	771,287
Repayments on long-term debt	—	(118,146)
Net settlements of derivatives	(72)	(82)
Net proceeds from issuance of common stock	145	146
Net payments on repurchase of common stock	—	(24,235)
Taxes paid on equity award distributions	(2,530)	(4,391)
Dividends paid	(44,112)	(44,303)
Net cash provided by (used in) financing activities	65,700	(374,201)
Net increase (decrease) in cash and cash equivalents	4,374	(3,306)
Cash and cash equivalents at beginning of period	212,844	220,229
Cash and cash equivalents at end of period	$217,218	$216,923
Supplemental Cash Flow Information:		
Cash paid during the period for:		
Interest	$44,274	$45,758

Taxes	1,040	467
Supplemental Noncash Information:		
Real estate securities retained from loan securitizations	$38,051	$1,834
Retention of mortgage servicing rights from loan securitizations and sales	7,387	5,688
Transfers from loans held-for-sale to loans held-for-investment	247,377	725,825
Transfers from loans held-for-investment to loans held-for-sale	459	359,005
Transfers from residential loans to real estate owned	2,044	5,867
Transfers from long-term debt to short-term debt	285,900	—

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2017
(Unaudited)

Note 1. Organization

Redwood Trust, Inc., together with its subsidiaries, focuses on investing in mortgages and other real estate-related assets and engaging in mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our mortgage banking activities. We operate our business in two segments: Investment Portfolio and Residential Mortgage Banking.

Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. References herein to “Redwood,” the “company,” “we,” “us,” and “our” include Redwood Trust, Inc. and its consolidate subsidiaries, unless the context otherwise requires.

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), beginning with its taxable year ended December 31, 1994. We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as “the REIT” or “our REIT.” We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as “our operating subsidiaries” or “our taxable REIT subsidiaries” or “TRS.”

We sponsor our Sequoia securitization program, which we use for the securitization of residential mortgage loans. References to Sequoia with respect to any time or period generally refer collectively to all the then consolidated Sequoia securitization entities for the periods presented. We have also engaged in securitization transactions in order to obtain financing for certain of our securities and commercial loans.

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2017 and December 31, 2016, and for the three and six months ended June 30, 2017 and 2016. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2016. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at June 30, 2017 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2017 should not be construed as indicative of the results to be expected for the full year.

Principles of Consolidation

In accordance with GAAP, we determine whether we must consolidate transferred financial assets and variable interest entities (“VIEs”) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans owned at the consolidated Sequoia entities are shown under Residential loans, held-for-investment, at fair value on our consolidated balance sheets. The asset-backed securities (“ABS”) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we recorded interest income on the loans owned at these entities and interest expense on the ABS issued by these entities as well as other income and expenses associated with these entities' activities. See Note 12 for further discussion on ABS issued.

See Note 4 for further discussion on principles of consolidation.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2017
(Unaudited)
Note 2. Basis of Presentation - (continued)

Use of Estimates
The preparation of financial statements requires us to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amounts and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported periods. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences could be material.
Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies
Included in Note 3 to the Consolidated Financial Statements of our 2016 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company’s consolidated financial condition and results of operations for the three and six months ended June 30, 2017.
Recent Accounting Pronouncements
Newly Adopted Accounting Standards Updates ("ASUs")
In January 2017, the FASB issued ASU 2017-03, "Accounting Changes and Error Corrections (Topic 250) and Investments - Equity Method and Joint Ventures (Topic 323)." This new guidance requires that companies evaluate ASUs that have not been adopted to determine the appropriate financial statement disclosures about the potential material effects of those ASUs on the financial statements when adopted. This new guidance is effective immediately. We adopted this guidance, as required, in the first quarter of 2017, which did not have a material impact on our consolidated financial statements.
In March 2016, the FASB issued ASU 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." This new guidance provides simplifications of the accounting for share-based payment transactions, including related income tax accounting, classification of awards, and classification on the statement of cash flows. In addition, this guidance permits the withholding of employee taxes related to the distribution of equity awards up to the maximum individual employee statutory tax rates. This new guidance is effective for fiscal years beginning after December 15, 2016 and early adoption is permitted. In the second quarter of 2016, we adopted this new guidance. Upon adoption, we elected to account for forfeitures on employee equity awards as they occur, rather than estimating expected forfeitures. The adoption of this guidance did not have a material impact on our consolidated financial statements.
Other Recent Accounting Pronouncements
In March 2017, the FASB issued ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20)." This new guidance shortens the amortization period for certain callable debt securities purchased at a premium by requiring the premium to be amortized to the earliest call date. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.
In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." This new guidance amends previous guidance on how to classify and present changes in restricted cash on the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2017. Early adoption is permitted. We plan to adopt this new guidance by the required date and we will modify the presentation of our cash flow statement as required.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory." This new guidance allows an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. It also eliminates the exceptions for an intra-entity transfer of assets other than inventory. This new guidance is effective for fiscal years beginning after December 15, 2017. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2017
(Unaudited)

Note 3. Summary of Significant Accounting Policies - (continued)

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." This new guidance provides guidance on how to present and classify certain cash receipts and cash payments in the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2017. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses." This new guidance provides a new impairment model that is based on expected losses rather than incurred losses to determine the allowance for credit losses. This new guidance is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for fiscal years beginning December 15, 2018. Currently, a significant portion of our financial instruments are measured at fair value, for which we do not maintain any allowances for loan losses in accordance with fair value accounting. As such, based on our initial evaluation of this new guidance, we do not believe the provisions in this guidance will have a material impact to how we account for these instruments. Separately, we account for our available-for-sale securities under the other-than-temporary impairment ("OTTI") model for debt securities. This new guidance changes the accounting for available-for-sale securities, including AFS securities purchased with credit deterioration. We are currently evaluating the impact that this update will have on our consolidated financial statements in regard to our available-for-sale securities. We plan to adopt this new guidance by the required date.

In February 2016, the FASB issued ASU 2016-02, "Leases." This new guidance requires lessees to recognize most leases on their balance sheet as a right-of-use asset and a lease liability. This new guidance retains a dual lease accounting model, which requires leases to be classified as either operating or capital leases for lessees, for purposes of income statement recognition. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. As discussed in Note 14, our only material leases are those related to our leased office space, for which future payments under these leases total $18 million at June 30, 2017. Based on our initial evaluation of this new guidance, and taking into consideration our current in-place leases, we do not expect that its adoption will have a material impact on our consolidated financial statements. We will continue evaluating this new standard and caution that any changes in our business or additional leases we may enter into could change our initial assessment.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." This new guidance amends accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. This new guidance also amends certain disclosure requirements associated with the fair value of financial instruments and it is effective for fiscal years beginning after December 15, 2017. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers.” The update modifies the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. In July 2015, the FASB approved a one year deferral of the effective date. Accordingly, the update is effective for us in the first quarter of 2018 with retrospective application to prior periods presented or as a cumulative effect adjustment in the period of adoption. Early adoption is permitted in the first quarter of 2017. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." This new guidance provides additional implementation guidance on how an entity should identify the unit of accounting for the principal versus agent evaluations. In May 2016, the FASB issued ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients," and in December 2016, the FASB issued ASU 2016-20, "Technical

Corrections and Improvements to Topic 606, Revenue from Contracts with Customers." These new ASUs provide more specific guidance on certain aspects of Topic 606. Based on our initial evaluation of these new accounting standards, we do not expect that their adoption will have a material impact on our consolidated financial statements, as financial instruments are explicitly scoped out of the standards and nearly all of our income is generated from financial instruments. We will continue evaluating these new standards and caution that any changes in our business or additional amendments to these standards could change our initial assessment.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2017
(Unaudited)

Note 3. Summary of Significant Accounting Policies - (continued)

Balance Sheet Netting
Certain of our derivatives and short-term debt are subject to master netting arrangements or similar agreements. Under GAAP, in certain circumstances we may elect to present certain financial assets, liabilities and related collateral subject to master netting arrangements in a net position on our consolidated balance sheets. However, we do not report any of these financial assets or liabilities on a net basis, and instead present them on a gross basis on our consolidated balance sheets.
The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at June 30, 2017 and December 31, 2016.
Table 3.1 – Offsetting of Financial Assets, Liabilities, and Collateral

June 30, 2017 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet [1] Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets [2]						
Interest rate agreements	$4,335	$ —	$4,335	$(3,513)	$(822)	$—
TBAs	3,381	—	3,381	(1,390)	(690)	1,301
Futures	9	—	9	—	—	9
Total Assets	$7,725	$ —	$7,725	$(4,903)	$(1,512)	$1,310
Liabilities [2]						
Interest rate agreements	$(64,087)	$ —	$(64,087)	$3,513	$60,574	$—
TBAs	(1,506)	—	(1,506)	1,391	37	(78)
Futures	(163)	—	(163)	—	163	—
Loan warehouse debt	(575,303)	—	(575,303)	575,303	—	—
Security repurchase agreements	(469,491)	—	(469,491)	469,491	—	—
Total Liabilities	$(1,110,550)	$ —	$(1,110,550)	$1,049,698	$60,774	$(78)

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 3. Summary of Significant Accounting Policies - (continued)

December 31, 2016 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet [(1)] Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets [(2)]						
Interest rate agreements	$24,980	$ —	$24,980	$(7,736)	$(4,784)	$12,460
TBAs	8,300	—	8,300	(3,936)	(4,364)	—
Total Assets	$33,280	$ —	$33,280	$(11,672)	$(9,148)	$12,460
Liabilities [(2)]						
Interest rate agreements	$(56,919)	$ —	$(56,919)	$7,736	$49,183	$—
TBAs	(4,681)	—	(4,681)	3,936	—	(745)
Futures	(928)	—	(928)	—	928	—
Loan warehouse debt	(485,544)	—	(485,544)	485,544	—	—
Security repurchase agreements	(305,995)	—	(305,995)	305,995	—	—
Total Liabilities	$(854,067)	$ —	$(854,067)	$803,211	$50,111	$(745)

(1) Amounts presented in these columns are limited in total to the net amount of assets or liabilities presented in the prior column by instrument. In certain cases, there is excess cash collateral or financial assets we have pledged to a counterparty (which may, in certain circumstances, be a clearinghouse) that exceed the financial liabilities subject to a master netting arrangement or similar agreement. Additionally, in certain cases, counterparties may have pledged excess cash collateral to us that exceeds our corresponding financial assets. In each case, any of these excess amounts are excluded from the table although they are separately reported in our consolidated balance sheets as assets or liabilities, respectively.

(2) Interest rate agreements, TBAs, credit default index swaps, and futures are components of derivatives instruments on our consolidated balance sheets. Loan warehouse debt, which is secured by residential mortgage loans, and security repurchase agreements are components of Short-term debt on our consolidated balance sheets.

For each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions within that category between us and a counterparty are subject to a master netting arrangement or similar agreement with that counterparty that provides for individual transactions to be aggregated and treated as a single transaction. For certain categories of these instruments, some of our transactions are cleared and settled through one or more clearinghouses that are substituted as our counterparty. References herein to master netting arrangements or similar agreements include the arrangements and agreements governing the clearing and settlement of these transactions through the clearinghouses. In the event of the termination and close-out of any of those transactions, the corresponding master netting agreement or similar agreement provides for settlement on a net basis. Any such settlement would include the proceeds of the liquidation of any corresponding collateral, subject to certain limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party. Such limitations should not inhibit the eventual practical realization of the principal benefits of those transactions or the corresponding master netting arrangement or similar agreement and any corresponding collateral.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation

GAAP requires us to consider whether securitizations we sponsor and other transfers of financial assets should be treated as sales or financings, as well as whether any VIEs that we hold variable interests in – for example, certain legal entities often used in securitization and other structured finance transactions – should be included in our consolidated financial statements. The GAAP principles we apply require us to reassess our requirement to consolidate VIEs each quarter and therefore our determination may change based upon new facts and circumstances pertaining to each VIE. This could result in a material impact to our consolidated financial statements during subsequent reporting periods.

Analysis of Consolidated VIEs

At June 30, 2017, we consolidated certain Sequoia securitization entities issued prior to 2012 that we determined were VIEs and for which we determined we were the primary beneficiary. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

(Dollars in Thousands)	June 30, 2017	December 31, 2016
Residential loans, held-for-investment	$707,686	$791,636
Restricted cash	148	148
Accrued interest receivable	925	1,000
Other assets	4,645	5,533
Total Assets	$713,404	$798,317
Accrued interest payable	$531	$518
Asset-backed securities issued	692,606	773,462
Total Liabilities	$693,137	$773,980
Number of VIEs	20	20

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 33 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheets, and classified those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

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Note 4. Principles of Consolidation - (continued)

The following table presents information related to securitization transactions that occurred during the three and six months ended June 30, 2017 and 2016.

Table 4.2 – Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2017	2016	2017	2016
Principal balance of loans transferred	$348,599	$344,890	$1,384,123	$344,890
Trading securities retained, at fair value	10,287	—	30,990	—
AFS securities retained, at fair value	1,905	1,834	7,060	1,834
MSRs recognized	—	2,131	7,123	2,131

The following table summarizes the cash flows during the three and six months ended June 30, 2017 and 2016 between us and the unconsolidated VIEs sponsored by us and accounted for as sales since 2012.

Table 4.3 – Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2017	2016	2017	2016
Proceeds from new transfers	$351,485	$352,042	$1,373,509	$352,042
MSR fees received	3,698	3,401	7,173	6,924
Funding of compensating interest, net	(41)	(77)	(79)	(156)
Cash flows received on retained securities	6,588	6,739	12,961	17,930

The following table presents the key weighted-average assumptions used to measure MSRs and securities retained at the date of securitization for securitizations completed during the three and six months ended June 30, 2017 and 2016.

Table 4.4 – Assumptions Related to Assets Retained from Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30, 2017			Three Months Ended June 30, 2016	
At Date of Securitization	MSRs	Senior Securities	Subordinate Securities	MSRs	Subordinate Securities
Prepayment rates	N/A	10 %	10 %	20 %	15 %
Discount rates	N/A	14 %	5 %	11 %	7 %
Credit loss assumptions	N/A	0.25 %	0.25 %	N/A	0.25 %

	Six Months Ended June 30, 2017			Six Months Ended June 30, 2016	
At Date of Securitization	MSRs	Senior Securities	Subordinate Securities	MSRs	Subordinate Securities
Prepayment rates	9 %	10 %	10 %	20 %	15 %
Discount rates	11 %	12 %	5 %	11 %	7 %
Credit loss assumptions	N/A	0.25 %	0.25 %	N/A	0.25 %

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation - (continued)

The following table presents additional information at June 30, 2017 and December 31, 2016, related to unconsolidated VIEs sponsored by Redwood and accounted for as sales since 2012.

Table 4.5 – Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	June 30, 2017	December 31, 2016
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	$69,825	$ 41,909
Subordinate securities, classified as AFS	216,269	234,025
Mortgage servicing rights	61,616	58,800
Maximum loss exposure (1)	$347,710	$ 334,734
Assets transferred:		
Principal balance of loans outstanding	$7,760,334	$ 6,870,398
Principal balance of loans 30+ days delinquent	18,144	21,427

(1) Maximum loss exposure from our involvement with unconsolidated VIEs pertains to the carrying value of our securities and MSRs retained from these VIEs and represents estimated losses that would be incurred under severe, hypothetical circumstances, such as if the value of our interests and any associated collateral declines to zero. This does not include, for example, any potential exposure to representation and warranty claims associated with our initial transfer of loans into a securitization.

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at June 30, 2017 and December 31, 2016.

Table 4.6 – Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood

June 30, 2017 (Dollars in Thousands)	MSRs	Senior Securities (1)	Subordinate Securities
Fair value at June 30, 2017	$61,616	$29,040	$257,054
Expected life (in years) (2)	7	6	13
Prepayment speed assumption (annual CPR) (2)	10 %	11 %	11 %
Decrease in fair value from:			
10% adverse change	$2,150	$1,224	$794
25% adverse change	5,161	2,910	1,976
Discount rate assumption (2)	11 %	9 %	6 %
Decrease in fair value from:			
100 basis point increase	$2,326	$1,144	$22,023
200 basis point increase	4,483	2,205	40,929
Credit loss assumption (2)	N/A	0.25 %	0.25 %
Decrease in fair value from:			
10% higher losses	N/A	$4	$1,348
25% higher losses	N/A	8	3,364

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation - (continued)

December 31, 2016 (Dollars in Thousands)	MSRs	Senior Securities (1)	Subordinate Securities
Fair value at December 31, 2016	$58,800	$26,618	$249,317
Expected life (in years) (2)	7	6	12
Prepayment speed assumption (annual CPR) (2)	11 %	8 %	12 %
Decrease in fair value from:			
10% adverse change	$2,226	$1,075	$997
25% adverse change	5,284	2,569	2,494
Discount rate assumption (2)	11 %	8 %	6 %
Decrease in fair value from:			
100 basis point increase	$2,088	$1,105	$19,574
200 basis point increase	4,032	2,128	36,574
Credit loss assumption (2)	N/A	0.25 %	0.25 %
Decrease in fair value from:			
10% higher losses	N/A	$19	$1,174
25% higher losses	N/A	49	2,933

(1) Senior securities included $29 million and $27 million of interest only securities at June 30, 2017 and December 31, 2016, respectively.
(2) Expected life, prepayment speed assumption, discount rate assumption, and credit loss assumption presented in the tables above represent weighted averages.

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at June 30, 2017, grouped by security type.

Table 4.7 – Third-Party Sponsored VIE Summary

(Dollars in Thousands)	June 30, 2017
Mortgage-Backed Securities	
Senior	$147,923
Re-REMIC	73,337
Subordinate	711,149
Total Investments in Third-Party Sponsored VIEs	$932,409

We determined that we are not the primary beneficiary of any third-party VIEs, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise solely hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs – we only account for our specific interests in them.

Our assessments of whether we are required to consolidate a VIE may change in subsequent reporting periods based upon changing facts and circumstances pertaining to each VIE. Any related accounting changes could result in a material impact to our financial statements.

Note 5. Fair Value of Financial Instruments

For financial reporting purposes, we follow a fair value hierarchy established under GAAP that is used to determine the fair value of financial instruments. This hierarchy prioritizes relevant market inputs in order to determine an “exit price” at the measurement date, or the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale. Level 1 inputs are observable inputs that reflect quoted prices for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for an asset or liability that are obtained through corroboration with observable market data. Level 3 inputs are unobservable inputs (e.g., our own data or assumptions) that are used when there is little, if any, relevant market activity for the asset or liability required to be measured at fair value.

In certain cases, inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level at which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2017 and December 31, 2016.

Table 5.1 – Carrying Values and Fair Values of Assets and Liabilities

	June 30, 2017		December 31, 2016	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	$836,291	$836,291	$834,193	$834,193
At lower of cost or fair value	1,080	1,212	1,206	1,365
Residential loans, held-for-investment				
At fair value	3,067,920	3,067,920	3,052,652	3,052,652
Trading securities	668,561	668,561	445,687	445,687
Available-for-sale securities	549,942	549,942	572,752	572,752
MSRs	63,770	63,770	118,526	118,526
Cash and cash equivalents	217,218	217,218	212,844	212,844
Restricted cash	2,006	2,006	8,623	8,623
Accrued interest receivable	20,101	20,101	18,454	18,454
Derivative assets	12,264	12,264	36,595	36,595
REO (1)	4,645	4,802	5,533	5,560
Margin receivable (1)	100,156	100,156	68,038	68,038
FHLBC stock (1)	43,393	43,393	43,393	43,393
Guarantee asset (1)	3,288	3,288	4,092	4,092
Commercial loans (1)	—	—	2,700	2,700
Pledged collateral (1)	42,963	42,963	42,875	42,875
Liabilities				
Short-term debt facilities	$1,044,794	$1,044,794	$791,539	$791,539
Accrued interest payable	9,939	9,939	9,608	9,608
Margin payable	2,020	2,020	12,783	12,783
Guarantee obligation	20,692	20,568	21,668	22,181
Derivative liabilities	69,175	69,175	66,329	66,329
ABS issued at fair value, net	692,606	692,606	773,462	773,462
FHLBC long-term borrowings	1,999,999	1,999,999	1,999,999	1,999,999
Convertible notes, net	447,848	464,042	482,195	493,365
Trust preferred securities and subordinated notes, net	138,512	100,440	138,489	96,255

(1) These assets are included in Other assets on our consolidated balance sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

During the three and six months ended June 30, 2017, we elected the fair value option for $13 million and $16 million of residential senior securities, $102 million and $244 million of subordinate securities, $1.20 billion and $2.29 billion of residential loans (principal balance), and $0.2 million and $8 million of MSRs, respectively. We anticipate electing the fair value option for all future purchases of residential loans that we may sell to third parties or transfer to securitizations, for MSRs purchased or retained from sales of residential loans, and for certain securities we purchase, including IO securities and fixed-rate securities rated investment grade or higher.
The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at June 30, 2017 and December 31, 2016, as well as the fair value hierarchy of the valuation inputs used to measure fair value.
Table 5.2 – Assets and Liabilities Measured at Fair Value on a Recurring Basis

June 30, 2017	Carrying Value	Fair Value Measurements Using		
(In Thousands)		Level 1	Level 2	Level 3
Assets				
Residential loans	$3,904,210	$—	$—	$3,904,210
Trading securities	668,561	—	—	668,561
Available-for-sale securities	549,942	—	—	549,942
Derivative assets	12,264	3,390	4,335	4,539
MSRs	63,770	—	—	63,770
Pledged collateral	42,963	42,963	—	—
FHLBC stock	43,393	—	43,393	—
Guarantee asset	3,288	—	—	3,288
Liabilities				
Derivative liabilities	$69,175	$1,669	$64,087	$3,419
ABS issued	692,606	—	—	692,606

December 31, 2016	Carrying Value	Fair Value Measurements Using		
(In Thousands)		Level 1	Level 2	Level 3
Assets				
Residential loans	$3,886,845	$—	$—	$3,886,845
Trading securities	445,687	—	—	445,687
Available-for-sale securities	572,752	—	—	572,752
Derivative assets	36,595	8,300	24,980	3,315
MSRs	118,526	—	—	118,526
Pledged collateral	42,875	42,875	—	—
FHLBC stock	43,393	—	43,393	—
Guarantee asset	4,092	—	—	4,092

Liabilities				
Derivative liabilities	$66,329	$5,609	$56,919	$3,801
ABS issued	773,462	—	—	773,462

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the six months ended June 30, 2017.

Table 5.3 – Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

	Assets						Liabilities
(In Thousands)	Residential Loans	Trading Securities	AFS Securities	MSRs	Guarantee Asset	Derivatives[1]	ABS Issued
Beginning balance - December 31, 2016	$3,886,845	$445,687	$572,752	$118,526	$ 4,092	$ (486)	$773,462
Acquisitions	2,329,355	260,351	27,238	7,701	—	—	—
Sales	(2,072,512)	(61,175)	(37,908)	(52,966)	—	—	—
Principal paydowns	(277,174)	(6,409)	(28,343)	—	—	—	(103,372)
Gains (losses) in net income, net	39,742	30,107	17,650	(9,491)	(804)	20,671	22,516
Unrealized losses in OCI, net	—	—	(1,447)	—	—	—	—
Other settlements, net [2]	(2,046)	—	—	—	—	(19,065)	—
Ending Balance - June 30, 2017	$3,904,210	$668,561	$549,942	$63,770	$ 3,288	$ 1,120	$692,606

(1) For the purpose of this presentation, derivative assets and liabilities, which consist of loan purchase commitments, are presented on a net basis.

(2) Other settlements, net for derivatives represents the transfer of the fair value of loan purchase commitments at the time loans are acquired to the basis of residential loans.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at June 30, 2017 and 2016. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and six months ended June 30, 2017 and 2016 are not included in this presentation.

Table 5.4 – Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2017 and 2016 Included in Net Income

	Included in Net Income			
	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2017	2016	2017	2016
Assets				
Residential loans at Redwood	$16,506	$8,165	$19,738	$32,969
Residential loans at consolidated Sequoia entities	11,038	7,592	19,452	(28,064)
Commercial loans	—	198	—	2,369
Trading securities	15,880	(230)	24,529	(8,353)
Available-for-sale securities	(128)	(305)	(245)	(305)
MSRs	(2,038)	(19,948)	(1,354)	(48,692)
Loan purchase commitments	994	6,873	1,111	7,248
Other assets - Guarantee asset	(558)	(952)	(804)	(2,377)
Liabilities				
Loan purchase commitments	$—	$—	$—	$—
Commercial secured borrowing	—	(198)	—	(2,369)
ABS issued	(11,977)	(8,574)	(22,516)	24,941

The following table presents information on assets recorded at fair value on a non-recurring basis at June 30, 2017. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our consolidated balance sheet at June 30, 2017.

Table 5.5 – Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at June 30, 2017

June 30, 2017	Carrying Value	Fair Value Measurements Using			Gain (Loss) for Three Months Ended June 30, 2017	Six Months Ended June 30, 2017
(In Thousands)		Level 1	Level 2	Level 3		
Assets						
Residential loans, at lower of cost or fair value	$ 856	$ —	$ —	$ 856	$ 2	$ 3
REO	4,118	—	—	4,118	(138)	(764)

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the net market valuation gains and losses recorded in each line item of our consolidated statements of income for the three and six months ended June 30, 2017 and 2016.

Table 5.6 – Market Valuation Gains and Losses, Net

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2017	2016	2017	2016
Mortgage Banking Activities, Net				
Residential loans held-for-sale, at fair value	$5,784	$5,859	$14,316	$11,298
Residential loan purchase commitments	10,406	10,852	20,671	23,487
Commercial loans, at fair value	—	—	—	433
Sequoia securities	—	(29)	—	1,455
Risk management derivatives, net	(5,310)	(9,240)	(6,710)	(21,994)
Total mortgage banking activities, net (1)	$10,880	$7,442	$28,277	$14,679
Investment Fair Value Changes, Net				
Residential loans held-for-investment, at Redwood	$8,354	$(647)	$6,021	$22,816
Trading securities	18,926	431	30,069	(5,170)
Valuation adjustments on commercial loans held-for-sale	300	—	300	—
Net investments in consolidated Sequoia entities	(987)	(251)	(2,797)	(1,831)
Risk sharing investments	(513)	(694)	(718)	(704)
Risk management derivatives, net	(17,838)	(9,600)	(22,965)	(45,410)
Impairments on AFS securities	(127)	(305)	(244)	(305)
Total investment fair value changes, net	$8,115	$(11,066)	$9,666	$(30,604)
MSR Income (Loss), Net				
MSRs	$(6,421)	$(27,265)	$(9,491)	$(71,869)
Risk management derivatives, net	3,040	21,153	2,291	62,210
Total MSR loss, net (2)	$(3,381)	$(6,112)	$(7,200)	$(9,659)
Total Market Valuation Gains (Losses), Net	$15,614	$(9,736)	$30,743	$(25,584)

(1) Mortgage banking activities, net presented above does not include fee income or provisions for repurchases that are components of Mortgage banking activities, net presented on our consolidated statements of income, as these amounts do not represent market valuation changes.

(2) MSR income (loss), net presented above does not include net fee income or provisions for repurchases that are components of MSR income, net on our consolidated statements of income, as these amounts do not represent market valuation adjustments.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

At June 30, 2017, our valuation policy and processes had not changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2016. The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

Table 5.7 – Fair Value Methodology for Level 3 Financial Instruments

June 30, 2017 (Dollars in Thousands, except Input Values)	Fair Value	Unobservable Input	Input Values Range			Weighted Average	
Assets							
Residential loans, at fair value:							
Jumbo fixed-rate loans	$3,027,340	Whole loan spread to TBA price	$2.59	-$3.56		$3.50	
		Whole loan spread to swap rate	175	-280	bps	278	bps
Jumbo hybrid loans	130,776	Prepayment rate (annual CPR)	15	-15	%	15	%
		Whole loan spread to swap rate	110	-200	bps	163	bps
Jumbo loans committed to sell	38,409	Whole loan committed sales price	$102.63	-$102.63		$102.63	
Loans held by consolidated Sequoia entities (1)	707,686	Liability price		N/A		N/A	
Residential loans, at lower of cost or fair value	856	Loss severity	15	-30	%	20	%
Trading and AFS securities	1,218,503	Discount rate	3	-13	%	5	%
		Prepayment rate (annual CPR)	—	-28	%	9	%
		Default rate	—	-33	%	3	%
		Loss severity	—	-40	%	23	%
MSRs	63,770	Discount rate	10	-18	%	11	%
		Prepayment rate (annual CPR)	5	-31	%	10	%
		Per loan annual cost to service	$82	-$82		$82	
Guarantee asset	3,288	Discount rate	11	-11	%	11	%
		Prepayment rate (annual CPR)	13	-13	%	13	%
REO	4,118	Loss severity	4	-100	%	30	%
Loan purchase commitments, net (2)	1,120	MSR multiple	0.6	-5.1	x	3.6	x
		Pull-through rate	10	-100	%	71	%
		Whole loan spread to TBA price	$2.59	-$3.56		$3.53	
			175	-280	bps	279	bps

		Whole loan spread to swap rate - fixed rate					
		Prepayment rate (annual CPR)	15	-15	%	15	%
		Whole loan spread to swap rate - hybrid	110	-190	bps	143	bps
Liabilities							
ABS issued (1)	692,606	Discount rate	4	-8	%	5	%
		Prepayment rate (annual CPR)	—	-20	%	16	%
		Default rate	1	-12	%	7	%
		Loss severity	20	-32	%	27	%

(1) The fair value of the loans held by consolidated Sequoia entities was based on the fair value of the ABS issued by these entities, which we determined were more readily observable, in accordance with accounting guidance for collateralized financing entities.

(2) For the purpose of this presentation, loan purchase commitment assets and liabilities are presented net.

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Note 5. Fair Value of Financial Instruments - (continued)

Determination of Fair Value
A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed herein. We generally use both market comparable information and discounted cash flow modeling techniques to determine the fair value of our Level 3 assets and liabilities. Use of these techniques requires determination of relevant inputs and assumptions, some of which represent significant unobservable inputs as indicated in the preceding table. Accordingly, a significant increase or decrease in any of these inputs – such as anticipated credit losses, prepayment rates, interest rates, or other valuation assumptions – in isolation would likely result in a significantly lower or higher fair value measurement.
Residential loans
Estimated fair values for residential loans are determined using models that incorporate various observable inputs, including pricing information from whole loan sales and securitizations. Certain significant inputs in these models are considered unobservable and are therefore Level 3 in nature. Pricing inputs obtained from market whole loan transaction activity include indicative spreads to indexed to be announced ("TBA") prices and indexed swap rates for fixed-rate loans and indexed swap rates for hybrid loans (Level 3). Pricing inputs obtained from market securitization activity include indicative spreads to indexed TBA prices for senior residential mortgage-backed securities ("RMBS") and indexed swap rates for subordinate RMBS, and credit support levels (Level 3). Other unobservable inputs also include assumed future prepayment rates. Observable inputs include benchmark interest rates, swap rates, and TBA prices. At June 30, 2017, our jumbo fixed-rate loans that were not committed to sell were priced using whole loan sale inputs. These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed, or credit support assumptions.
Real estate securities
Real estate securities include residential, commercial, and other asset-backed securities that are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators that are factored into the analysis include bid/ask spreads, the amount and timing of credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The estimated fair value of our securities would generally decrease based upon an increase in default rates, serious delinquencies, or a decrease in prepayment rates or credit support.
As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at June 30, 2017, we received dealer price indications on 76% of our securities, representing 83% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were within 1% of the aggregate average dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.
Derivative assets and liabilities
Our derivative instruments include swaps, swaptions, TBAs, financial futures, and loan purchase commitments ("LPCs"). Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets.

Fair values of TBAs and financial futures are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

LPC fair values for jumbo loans are estimated based on the estimated fair values of the underlying loans (as described in "Residential loans" above) as well as the probability that the mortgage loan will be purchased (the "Pull-through rate") (Level 3).

For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management’s best estimate is used (Level 3).

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

MSRs
MSRs include the rights to service jumbo and conforming residential mortgage loans. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Changes in the fair value of MSRs occur primarily due to the collection/realization of expected cash flows, as well as changes in valuation inputs and assumptions. Estimated fair values are based on applying the inputs to generate the net present value of estimated future MSR income (Level 3). These discounted cash flow models utilize certain significant unobservable inputs including market discount rates, assumed future prepayment rates of serviced loans, and the market cost of servicing. An increase in these unobservable inputs would generally reduce the estimated fair value of the MSRs.
As part of our MSR valuation process, we received a valuation estimate from a third-party valuations firm. In the aggregate, our internal valuation of the MSRs were within 2% of the third-party valuation.
FHLBC Stock
Our Federal Home Loan Bank ("FHLB") member subsidiary is required to purchase Federal Home Loan Bank of Chicago ("FHLBC") stock under a borrowing agreement between our FHLB-member subsidiary and the FHLBC. Under this agreement, the stock is redeemable at face value, which represents the carrying value and fair value of the stock (Level 2).
Guarantee Asset
The guarantee asset represents the estimated fair value of cash flows we are contractually entitled to receive related to a risk sharing arrangement with Fannie Mae. Significant inputs in the valuation analysis are Level 3, due to the nature of this asset and the lack of market quotes. The fair value of the guarantee asset is determined using a discounted cash flow model, for which significant unobservable inputs include assumed future prepayment rates and market discount rate (Level 3). An increase in prepayment rates or discount rate would generally reduce the estimated fair value of the guarantee asset.
Pledged Collateral
Pledged collateral consists of cash and U.S. Treasury securities held by a custodian in association with certain agreements we have entered into. Treasury securities are carried at their fair value, which is determined using quoted prices in active markets (Level 1).
Cash and cash equivalents
Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less. Fair values equal carrying values (Level 1).
Restricted cash
Restricted cash primarily includes interest-earning cash balances related to risk sharing transactions with the Agencies as well as at consolidated Sequoia entities for the purpose of distribution to investors and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values (Level 1).
Accrued interest receivable and payable
Accrued interest receivable and payable includes interest due on our assets and payable on our liabilities. Due to the short-term nature of when these interest payments will be received or paid, fair values approximate carrying values (Level 1).
REO
REO includes properties owned in satisfaction of foreclosed loans. Fair values are determined using available market quotes, appraisals, broker price opinions, comparable properties, or other indications of value (Level 3).

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Margin receivable

Margin receivable reflects cash collateral we have posted with our various derivative and debt counterparties as required to satisfy margin requirements. Fair values approximate carrying values (Level 2).

Guarantee Obligations

In association with our risk sharing transactions with the Agencies, we have made certain guarantees. These obligations are initially recorded at fair value and subsequently carried at amortized cost. Fair values of guarantee obligations are determined using internal models that incorporate certain significant inputs that are considered unobservable and are therefore Level 3 in nature. Pricing inputs include assumed future prepayment rates, credit losses, and market discount rates. A decrease in future prepayment rates or discount rates, or an increase in credit losses, would generally cause the fair value of the guarantee obligations to decrease (become a larger liability).

Short-term debt

Short-term debt includes our credit facilities that mature within one year. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2). Additionally, at June 30, 2017, short-term debt included unsecured convertible senior notes with a maturity of less than one year. The fair value of the convertible notes is determined using quoted prices in generally active markets (Level 2).

ABS issued

ABS issued includes asset-backed securities issued through the Sequoia securitization entities. These instruments are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. For ABS issued, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators factored into the analysis include bid/ask spreads, the amount and timing of collateral credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). A decrease in credit losses or discount rate, or an increase in prepayment rates, would generally cause the fair value of the ABS issued to decrease (become a larger liability).

FHLBC Borrowings

FHLBC borrowings include amounts borrowed from the FHLBC that are secured, generally by residential mortgage loans. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2).

Convertible notes

Convertible notes include unsecured convertible and exchangeable senior notes. Fair values are determined using quoted prices in generally active markets (Level 2).

Trust preferred securities and subordinated notes

Estimated fair values of trust preferred securities and subordinated notes are determined using discounted cash flow analysis valuation techniques. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 6. Residential Loans
We acquire jumbo residential loans from third-party originators. The following table summarizes the classifications and carrying values of the residential loans owned at Redwood and at consolidated Sequoia entities at June 30, 2017 and December 31, 2016.
Table 6.1 – Classifications and Carrying Values of Residential Loans

June 30, 2017			
(In Thousands)	Redwood	Sequoia	Total
Held-for-sale			
At fair value	$836,291	$—	$836,291
At lower of cost or fair value	1,080	—	1,080
Total held-for-sale	837,371	—	837,371
Held-for-investment at fair value	2,360,234	707,686	3,067,920
Total Residential Loans	$3,197,605	$707,686	$3,905,291

December 31, 2016			
(In Thousands)	Redwood	Sequoia	Total
Held-for-sale			
At fair value	$834,193	$—	$834,193
At lower of cost or fair value	1,206	—	1,206
Total held-for-sale	835,399	—	835,399
Held-for-investment at fair value	2,261,016	791,636	3,052,652
Total Residential Loans	$3,096,415	$791,636	$3,888,051

At June 30, 2017, we owned mortgage servicing rights associated with $2.36 billion (principal balance) of consolidated residential loans purchased from third-party originators. The value of these MSRs is included in the carrying value of the associated loans on our consolidated balance sheets. We contract with licensed sub-servicers that perform servicing functions for these loans.
Residential Loans Held-for-Sale
At Fair Value
At June 30, 2017, we owned 1,062 loans held-for-sale at fair value with an aggregate unpaid principal balance of $0.82 billion and a fair value of $0.84 billion, compared to 1,114 loans with an aggregate unpaid principal balance of $0.83 billion and a fair value of $0.83 billion at December 31, 2016. At June 30, 2017 and December 31, 2016, none of these loans were greater than 90 days delinquent or in foreclosure.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 6. Residential Loans - (continued)

During the three and six months ended June 30, 2017, we purchased $1.20 billion and $2.29 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold $0.67 billion and $2.04 billion (principal balance) of loans, respectively, for which we recorded a net market valuation losses of $6 million and $14 million, respectively, through Mortgage banking activities, net on our consolidated statements of income. At June 30, 2017, loans held-for-sale with a market value of $645 million were pledged as collateral under short-term borrowing agreements.

During the three and six months ended June 30, 2016, we purchased $1.32 billion and $2.51 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold $0.81 billion and $2.05 billion (principal balance) of loans, respectively, for which we recorded net market valuation gains of $6 million and $11 million, respectively, through Mortgage banking activities, net on our consolidated statements of income.

At Lower of Cost or Fair Value

At June 30, 2017 and December 31, 2016, we held six and seven residential loans, respectively, at the lower of cost or fair value with $1 million and $2 million in outstanding principal balance, respectively, and a carrying value of $1 million for both periods. At both June 30, 2017 and December 31, 2016, one of these loans with an unpaid principal balance of $0.3 million was greater than 90 days delinquent and none of these loans were in foreclosure.

Residential Loans Held-for-Investment at Fair Value

At Redwood

At June 30, 2017, we owned 3,188 held-for-investment loans at Redwood with an aggregate unpaid principal balance of $2.32 billion and a fair value of $2.36 billion, compared to 3,068 loans with an aggregate unpaid principal balance of $2.23 billion and a fair value of $2.26 billion at December 31, 2016. At June 30, 2017, none of these loans were greater than 90 days delinquent or in foreclosure. At December 31, 2016, one of these loans with an unpaid principal balance of $0.2 million was greater than 90 days delinquent and none of these loans were in foreclosure.

During the three and six months ended June 30, 2017, we transferred loans with a fair value of $62 million and $247 million, respectively, from held-for-sale to held-for-investment. During both the three and six months ended June 30, 2017, we transferred loans with a fair value of $0.5 million from held-for-investment to held-for-sale. During the three and six months ended June 30, 2017, we recorded net market valuation gains of $8 million and $6 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net on our consolidated statements of income. At June 30, 2017, loans with a fair value of $2.35 billion were pledged as collateral under a borrowing agreement with the FHLBC.

During the three and six months ended June 30, 2016, we transferred loans with a fair value of $65 million and $725 million, respectively, from held-for-sale to held-for-investment. During the three and six months ended June 30, 2016, we transferred loans with a fair value of $2 million and $56 million, respectively, from held-for-investment to held-for-sale. During the three and six months ended June 30, 2016, we recorded a net market valuation loss of $1 million and a net market valuation gain of $23 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net on our consolidated statements of income.

At June 30, 2017, the outstanding loans held-for-investment at Redwood were prime-quality, first lien loans, of which 95% were originated between 2013 and 2017, and 5% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 771 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 66% (at origination). At June 30, 2017, these loans were comprised of 97.0% fixed-rate loans with a weighted average coupon of 4.13%, and the remainder were hybrid or ARM loans with a weighted average coupon of 4.04%.

At Consolidated Sequoia Entities

At June 30, 2017, we owned 3,453 held-for-investment loans at consolidated Sequoia entities, with an aggregate unpaid balance of $781 million and a fair value of $708 million, as compared to 3,735 loans at December 31, 2016, with an aggregate unpaid principal balance of $887 million and a fair value of $792 million. At origination, the weighted average FICO score of borrowers backing these loans was 727, the weighted average LTV ratio of these loans was 66%, and the loans were nearly all first lien and prime-quality.

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Note 6. Residential Loans - (continued)

At June 30, 2017 and December 31, 2016, the unpaid principal balance of loans at consolidated Sequoia entities delinquent greater than 90 days was $15 million and $19 million, respectively, and the unpaid principal balance of loans in foreclosure was $12 million and $11 million, respectively. During the three and six months ended June 30, 2017, we recorded net market valuation gains of $11 million and $19 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income. During the three and six months ended June 30, 2016, we recorded a net market valuation gain of $8 million and a net market valuation loss of $28 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income.

Note 7. Real Estate Securities

We invest in real estate securities. The following table presents the fair values of our real estate securities by type at June 30, 2017 and December 31, 2016.

Table 7.1 – Fair Values of Real Estate Securities by Type

(In Thousands)	June 30, 2017	December 31, 2016
Trading	$668,561	$ 445,687
Available-for-sale	549,942	572,752
Total Real Estate Securities	$1,218,503	$ 1,018,439

Our real estate securities include mortgage-backed securities, which are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior security interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior security interests, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests. We further separate our subordinate securities into mezzanine and subordinate, where mezzanine includes securities initially rated AA through BBB- and issued in 2012 or later. Nearly all of our securities are supported by collateral that was designated as prime as of issuance.

Trading Securities

The following table presents the fair value of trading securities by position and collateral type at June 30, 2017 and December 31, 2016.

Table 7.2 – Trading Securities by Position and Collateral Type

(In Thousands)	June 30, 2017	December 31, 2016
Senior Securities	$48,633	$ 37,067
Subordinate Securities		
Mezzanine	377,286	256,226
Subordinate	242,642	152,394
Total Subordinate Securities	619,928	408,620
Total Trading Securities	$668,561	$ 445,687

We elected the fair value option for certain securities and classify them as trading securities. Our trading securities include both residential and commercial/multifamily securities. At June 30, 2017, trading securities with a carrying value of $348 million were pledged as collateral under short-term borrowing agreements. See Note 11 for additional information on short-term debt.

At June 30, 2017 and December 31, 2016, our senior trading securities were comprised of interest-only securities, for which there is no principal balance, and our subordinate trading securities had an unpaid principal balance of $628 million and $434 million, respectively.

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Note 7. Real Estate Securities - (continued)

At June 30, 2017 and December 31, 2016, subordinate trading securities included $230 million and $152 million, respectively, of Agency residential mortgage credit risk transfer (or "CRT") securities, $41 million and $15 million, respectively, of Sequoia securities, $179 million and $149 million, respectively, of other third-party residential securities, and $170 million and $92 million, respectively, of third-party commercial/multifamily securities.

During the three and six months ended June 30, 2017, we acquired $107 million and $261 million (principal balance), respectively, of senior and subordinate securities for which we elected the fair value option and classified as trading, and sold $51 million and $60 million, respectively, of such securities. During the three and six months ended June 30, 2016, we acquired $83 million and $133 million (principal balance), respectively, of senior and subordinate securities for which we elected the fair value option and classified as trading, and sold $18 million and $236 million, respectively, of such securities.

During the three and six months ended June 30, 2017, we recorded net market valuation gains of $19 million and $30 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income. During the three and six months ended June 30, 2016, we recorded a net market valuation gain of $0.4 million and a net market valuation loss of $4 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income.

AFS Securities

The following table presents the fair value of our available-for-sale securities by position and collateral type at June 30, 2017 and December 31, 2016.

Table 7.3 – Available-for-Sale Securities by Position and Collateral Type

(In Thousands)	June 30, 2017	December 31, 2016
Senior Securities	$128,329	$ 136,546